BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, DC 20554

In the Matter of	)	
	)	
Review of the Commission's Rules Regarding	)	
The Pricing of Unbundled Network Elements	)	WC Docket No. 03-173
And the Resale of Service by Incumbent Local	)	
Exchange Carriers	)	

COMMENTS OF THE NATIONAL ASSOCIATION OF STATE UTILITY CONSUMER ADVOCATES

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TABLE OF CONTENTS

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I. INTRODUCTION

The National Association of State Utility Consumer Advocates (NASUCA)[1] hereby submits these comments in response to the Federal Communications Commission's (FCC or Commission) Notice of Proposed Rulemaking (NPRM) in this docket. These Comments are supported by the attached Affidavit of David J. Gabel and Robert Loube (hereafter Gabel/Loube).

The Commission asks parties to comment on whether it should retain as the primary goals of its Unbundled Network Element (UNE) pricing rules:

1) To set UNE prices in a manner that sends efficient entry and investment signals to all competitors; and

2) To provide Incumbent Local Exchange Carriers (ILECs) an opportunity to recover the forward-looking costs of providing UNEs.[2]

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[1] NASUCA is an association of 44 advocate offices in 42 states and the District of Columbia. NASUCA's members are designated by laws of their respective jurisdictions to represent the interests of utility consumers before state and federal regulators and in the courts. See, e.g., Ohio Rev. Code Chapter 4911.

[2] NPRM, ¶ 38.

NASUCA believes that these should remain the primary goals of the FCC's UNE pricing rules. The purpose of setting UNE prices is to set the prices for inputs to competitive local telecommunications services. This is pivotal to implementing the Telecommunications Act of 1996. It would make no sense, and be contrary to the Act, to set prices in a manner that does not send "efficient entry and investment signals to all competitors." The purpose of the Act is to expand competition for telecommunications services. If the Commission were to change the Total Element Long Run Incremental Costs (TELRIC) rules so that prices do not send efficient entry and investment signals to competitors, the very foundation of the Act itself would crumble. There is no evidence whatsoever that the existing embedded networks of the ILECs are efficient or that prices set based in whole or in part on their embedded costs would send the appropriate signal to the telecommunications marketplace.[3]

As to the second objective, pursuant to the Act and the FCC's TELRIC rules, ILECs are entitled to recover the forward-looking costs of providing UNEs. The ILECs have a fair opportunity to present evidence about what the appropriate forward-looking costs and prices are under the existing TELRIC rules. State commissions have extensive experience examining cost models and setting prices and are well positioned to render good decisions based on careful review of the evidence specific to their states.[4]

For these reasons, and those set forth below, the Commission's primary UNE pricing goals are best achieved by retaining the existing TELRIC pricing regime,

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[3] Indeed, AT&T and its affiliated Bell Companies have advocated since the early 1970s that the appropriate "Costs for Pricing Decisions" was Long Run Incremental Costs; not embedded costs.

[4] Gabel/Loube ¶ 86.

including the key role approved by the Supreme Court for the states to examine TELRIC cost analyses and set UNE prices.[5]

During the past two decades, NASUCA and its member offices have had extensive experience analyzing telecommunications costs and prices in both state and federal proceedings, including numerous state TELRIC proceedings. Based on this experience, we urge the Commission to carefully consider the following points, which we set forth in more detail in these Comments and the supporting affidavit.

> •Although a forward-looking TELRIC cost analysis is, by definition, hypothetical in nature, it is the most appropriate and reasonable approach to pricing UNEs.
>
> •The reliance on forward-looking TELRIC costs to set UNE prices is consistent with both economic theory and regulatory practice.
>
> •The TELRIC methodology does not result in UNE prices that are unreasonably low.
>
> •Setting prices based on a cost methodology that employs "real world attributes," i.e., assumptions and data appropriate for use in embedded cost models, would be anti-competitive.
>
> • A costing/pricing regime focused more closely on the existing network of an ILEC would not be easier for state commissions to implement than the current TELRIC regime and would not eliminate the speculation that takes place now during a UNE pricing proceeding.
>
> •Transparency and verifiability of cost models are extremely important and should be criteria for judging the merits of the resultant costs and prices.
>
> •The time and effort that states have devoted to examining TELRIC cost analyses and setting UNE prices is appropriate and should continue.
>
> •State-approved UNE rates are predictable and reasonable.
>
> •It is to be expected that UNE prices will change as a result of changes in customer demand, technology, network architectures, Operation Support Systems,

[5] AT&T Corp. v. Iowa Utilities Board, 525 U.S. 366, 384-385 (1999).

and business and operational practices. State commissions continue to be the proper bodies for the examination of the changes on the forward-looking costs.[6]

•It is extremely unlikely that the Commission could succeed in an effort to set UNE rates to promote facilities-based entry.

II. ALTHOUGH A FORWARD-LOOKING TELRIC COST ANALYSIS IS, BY DEFINITION, HYPOTHETICAL IN NATURE, IT IS THE MOST APPROPRIATE AND REASONABLE APPROACH TO PRICING UNES.

A. The Existing TELRIC Methodology is Superior to an Embedded Cost Methodology for the Purpose of Setting UNE Prices.

While affirming its support for a forward-looking cost methodology, the Commission nonetheless seeks comment on "... an approach that bases UNE prices on a cost inquiry that is more firmly rooted in the real-world attributes of the existing network, rather than the speculative attributes of a purely hypothetical network.[7]

While such an approach might seem attractive at first blush, it rests on the faulty premise that the costs and prices generated pursuant to the existing TELRIC rules are more speculative than those relying on the embedded cost data associated with existing Regional Bell Operating Company (RBOC) networks. Forward-looking costs are hypothetical by their very nature. This does not mean that the inputs or the resulting costs and prices established under the current TELRIC rules are unreasonable. Nor does it follow that TELRIC-compliant forward-looking costs and prices are any more speculative than the inputs underlying the purported costs of the existing network, referred to by the RBOCs as "actual" costs.

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[6] This is also true for retail Total Service Long Run Incremental Costs (TSLRIC).

[7] NPRM, ¶ 4.

The alternative to using hypothetical forward-looking costs to set prices is to rely on embedded costs. There are two problems with this approach. First, it is manifestly incompatible with the primary goal of sending efficient investment and entry signals to all competitors.[8] In markets that are subject to competitive forces, booked investments and expenses associated with booked investments do not influence prices for products sold at the retail level or inputs sold at wholesale level. If there are no barriers to entry, new entrants base the decision to enter and invest upon the cost of the most efficient, state of the art technology, not the cost of older equipment and facilities.

The second problem is that the embedded costs themselves have been demonstrated to be hypothetical. For example, the Commission's audits of continuing property records revealed that approximately 11 percent of the reported embedded book central office plant of the RBOCs did not exist.[9] No such audits have been undertaken to examine the claimed loop plant investment for any RBOC. Consequently, reliance on embedded costs is at least as hypothetical and speculative as reliance on forward-looking costs.

A forward-looking cost analysis, which the Commission seeks to preserve and which the Supreme Court found lawful,[10] is, by definition, hypothetical. Nonetheless, it is far superior to an embedded cost analysis for the purpose of setting UNE rates.[11] Prices based on TELRIC studies send the appropriate price signals to the marketplace.

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[8] Gabel/Loube, ¶ 23.

[9] Gabel/Loube, ¶ 14, fn. 8.

[10] *Verizon v. FCC*, 535 U.S. 467, 523 (2002).

[11] Gabel/Loube ¶ 23. For the same reasons, it would be equally inappropriate to use embedded costs to set retail rates.

Moreover, when a state commission examines a TELRIC cost study, it has the ability to identify all of the state-specific key assumptions underlying the study, including whether a network is efficiently designed. With an embedded study, a state commission has no hope of being able to verify that the plant in question even exists. Further, an embedded analysis cannot generate prices that will send the appropriate entry and investment signals to the marketplace and, thus, would defeat the purpose of the Act.

B. The Reliance Upon Forward-Looking TELRIC Costs to set UNE Prices is Consistent with Both Economic Theory and Regulatory Practice.

It is well known that there is a large body of economic literature concerning the appropriateness of pricing features, functions, network elements and services based on forward-looking costs as applied to telecommunications regulation.[12] It is important to recognize that the Commission and the RBOCs have consistently advocated the use of hypothetical, forward looking cost studies.[13] Since the 1970's, the RBOCs have consistently advocated using forward-looking economic costs to set price floors for their retail products.[14] The use of forward-looking costs to set UNE prices is consistent with both economic theory and regulatory practice spanning the past three decades, and it should not be abandoned now.

[12] NPRM, fn. 69.

[13] Gabel/Loube, ¶ 17.

[14] Gabel/Loube, ¶ 14.

C. The TELRIC Demand Approach Does Not Cause Unreasonably Low Prices.

The NPRM proposes to resolve a "key internal tension" it believes in inherent in TELRIC: the assumption that for some purposes rates should reflect a market with widespread facilities-based competition but, for other purposes, rates should reflect a market with a single dominant carrier."[15] The Commission expands upon this concern in paragraphs 50-51:

> One of the central tensions in the application of the TELRIC methodology is that it purports to replicate the conditions of a competitive market by assuming that the latest technology is deployed throughout the hypothetical network, while at the same time assuming that this hypothetical network benefits from the economies of scale associated with serving all of the lines in a study area. In the real world, however, even in extremely competitive markets, firms do not instantaneously replace all of their facilities with every improvement in technology. Thus, even the most efficient carrier's network will reflect a mix of new and older technology at any given time.
>
> Simultaneously assuming a market inhabited by multiple competitors and one with a ubiquitous carrier with a very large market share may work to reduce estimates of forward-looking costs below the costs that would actually be found in an extremely competitive market.[16]

An efficient entrant will enter with the most efficient technology available at the time of entry. Since the Commission has, rightly, reaffirmed its commitment to forward-looking costs -- which by definition are developed based on assuming efficient, forward looking technology -- the key question in addressing this perceived conflict is whether the application of TELRIC results in a situation where prices are set too low due to unreasonable assumptions about demand.

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[15] NPRM, ¶ 4.

[16] NPRM, ¶ 50-51.

TELRIC demand assumptions are reasonable. TELRIC cost studies are largely based on the actual level of demand that is met by the ILECs.[17] The cost estimates are developed by starting with the quantity of service delivered by the ILEC. Simultaneously, the cost models take into account the fact that the ILEC, while dominant, faces competitors and shares facilities with other utilities. Any other set of assumptions would make no sense. These are, in fact, the demand conditions that exist in the "real world" and affect "actual costs." The ILEC is not the sole supplier and, therefore, it would be inappropriate to assume that all demand in a market is served by one supplier. If such an assumption was made, the cost study would understate the true economic cost of production because the model would assume economies of scale that are not achieved. By the same token, it is not reasonable to assume that the ILEC is non-dominant. UNEs are provided in markets where the ILEC is dominant and competitors would be impaired if not for the availability of network elements.[18]

In fact, state commissions do take into account the growing market share of CLECs and the dominance of ILECs in the course of examining TELRIC cost models and setting UNE prices. For example, in its generic cost docket the Washington Utilities

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[17] Paragraph 49 of the NPRM appears to suggest, incorrectly, that the TELRIC models presume that the ILEC builds a network to serve the total demand for a study area. Neither of the sources cited in the NPRM (Local Competition Order, 11 FCC Rcd at 15848-49, Paragraph 685; or 47 C.F..R. § 51.505(b)(1)), state or imply that the cost analyst should assume that the ILEC serves the entire market. Neither have the cost studies been designed to estimate the cost of serving the entire market. Gabel/Loube, ¶ 32, fn. 28.

[18] Gabel/Loube, ¶ 37-38.

and Transportation Commission (WUTC) explicitly adjusted the loop cost estimates to reflect the fact that unit costs would increase due to the growth of competition.[19] Furthermore, the Order's findings on structure sharing were founded in the record evidence regarding structure sharing in the state of Washington. A significant amount of this evidence was collected through the depositions of field engineers.[20]

We urge the FCC to review the WUTC decisions so that it may understand how state regulators take into account the growing market share and the dominance of ILECs in the course of setting UNE prices. The WUTC's approach illustrates the states' desire to develop cost estimates that reflect actual operations of the market. A departure from this approach would result in inferior cost estimates that did not reflect actual operations of the telecommunications marketplace.[21]

D. The TELRIC Methodology Does Not Produce Unrealistically Low UNE Prices.

The Commission notes that critics of TELRIC claim that the methodology is flawed "due to an alleged emphasis on unrealistic efficiency assumptions" that results in

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[19] Washington Utilities and Transportation Commission <u>In the Matter of the Pricing Proceeding for Interconnection, Unbundled Network Elements, Transport, and Termination, and Resale</u>, Docket No. UT-960369, Eighth Supplemental Order, April 16, 1998 (WUTC Eighth Supplemental Order), Paragraphs 61, 269-70. Also see *id.*, summary table, Appendix B: "Factor into the loop cost the likelihood that a drop in market share increases the unit cost".

Washington was not the only state to take this approach. For example, the New Mexico Corporation Commission also took into account the impact of competition when developing the cost of the unbundled loop. The Commission noted its agreement with U S WEST that "a loss in market share [s]hould be reflected in the estimate of the economic cost of the loop." <u>In the Matter of the Consideration of the Adoption of a Rule Concerning Costing Methodologies</u>, Docket No. 96-310-TC, July 15, 1998, Paragraphs 83-85, quote at paragraph 84.

[20] Gabel/Loube, ¶ 39; WUTC Eighth Supplemental Order, Paragraphs 43-76.

[21] Gabel/Loube, ¶ 40.

rates that are far below an incumbent LEC's "actual" costs.[22] It is not surprising that TELRIC's main critics, the RBOCs, make this claim. However, the assertion is not supported by any empirical evidence.

The appropriate test for determining the reasonableness of rates is the documentation provided by a party that aids a commission's validation of the sponsored input values, and the operation of the cost model. When studies are forward-looking, which the Commission rightly continues to endorse, the validity of a price is not established by comparing the price to the historical cost. Rather, a cost analyst must explain the basis for sponsoring an input value and provide documentation that supports the proposed value, as well as documenting the modeling process that utilizes the inputs. Out of this process will emerge a cost estimate for a rate element. The sanity check for TELRIC rates is achieved by testing the reasonableness of the inputs to the cost model, as well as a review of the operations of the cost model.[23]

As demonstrated by Dr. Gabel and Dr. Loube, state-approved UNE rates are predictable and reasonable. This is discussed in more detail below, in section V. of these Comments, and the attached Gabel/Loube affidavit at paragraphs 88-94. There is ample reason to question whether the ILECs' "actual costs" are, in reality, accurate. The RBOCs' claim certainly cannot be supported by public data.[24]

The recent study by Beard, Ford and Klein, "The Financial Implications of the UNE-Platform: A Review of the Evidence," casts further doubt upon claims that TELRIC

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[22] NPRM, ¶ 5.

[23] Gabel/Loube, ¶ 65-66.

[24] Gabel/Loube, ¶ 14, fn.8 and ¶ 151-153.

prices are unreasonably low.[25] The study, based on "realistic revenue and current cost figures usable for financial analysis … suggests that the wholesale business, taken alone, is profitable for the BOCs."[26] Specifically, Beard, Ford and Klein calculate that the BOCs receive implied pre-tax returns of 16%-27% on the UNE-P.[27]

Further, Yale M. Braunstein of the University of California at Berkeley reviewed SBC's UNE-P costs and revenues.[28] Professor Braunstein found that current California UNE-P rates "still leave room for a profit in this wholesale business of between 9% and 42%."[29] As Professor Braunstein stated, "[I]t is clear that one can conclude that SBC is earning a reasonable profit on its wholesale service."[30]

III. A COSTING/PRICING REGIME FOCUSED MORE CLOSELY ON THE EXISTING NETWORK OF AN ILEC WOULD NOT BE EASIER FOR STATE COMMISSIONS TO IMPLEMENT THAN THE CURRENT TELRIC REGIME AND WOULD NOT ELIMINATE THE SPECULATION THAT TAKES PLACE NOW DURING A UNE PRICING PROCEEDING.

The Commission requests comment on "whether a regime focused more closely on the existing network of an incumbent LEC would be easier for state commissions to

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[25] Hereafter referred to as "Beard, Ford and Klein," forthcoming in CommLaw Conspectus, Journal of Communications Law and Policy (Fall/Winter 2003); available at http://www.telepolicy.com/finapp.pdf.

[26] Beard, Ford and Klein at 1; see also *id*. at 7-8. See also CompTel, "Wholesale Lies: The Truth About RBOC UNE-P Costs" (May 2003), available at http://www.comptel.org/filings/belowcoststudy_may21_2003.pdf.

[27] Beard, Ford and Klein at 20.

[28] Yale M. Braunstein, "The Role of UNE-P in Vertically Integrated Telephone Networks: Ensuring Healthy and Competitive Local, Long-Distance and DSL Markets," (May 2003), available at http://www.sims.berkeley.edu/%7Ebigyale/UNE/UCB_Study_UNE_May_2003.pdf.

[29] *Id*. at 7.

[30] *Id*. at 7, n.7.

implement than the current TELRIC regime" and whether such an approach would "eliminate much of the speculation that now takes place within the context of a UNE pricing proceeding…."[31] Based upon the extensive experience of NASUCA offices who have participated in these proceedings across the country, the answer to both questions is, unequivocally, no.

Abandoning TELRIC and turning to a costing/pricing regime focusing "more on the existing network" would, by definition, involve developing a new costing/pricing approach that would somehow combine both forward-looking and embedded costing principles, assumptions and data. This would make the process of determining UNE prices more complicated, not less. States have devoted substantial time and resources to implementing the TELRIC rules, and have developed a substantial level of expertise with TELRIC methods. If TELRIC were abandoned now, it would make the states' job more difficult, not easier.

Nor would focusing more closely on the existing network eliminate the speculation that now takes place during a UNE pricing proceeding. On the contrary, speculation would increase because, although examining the costs of the existing network sounds like a straightforward proposition, it is not. Most of the available public domain data are reported in ARMIS. The ARMIS reporting systems were developed to help the Commission determine access prices and track jurisdictional separations data. The ARMIS systems were not built to function as the data input source for forward-looking cost models.[32] Moreover, pursuant to the Commission's order, separations data

[31] NPRM, ¶ 60.

[32] Gabel/Loube, ¶ 151-153.

(categories and sub-categories) was frozen at calendar year 2000 percentage ratios. The difference between reported and actual investments affects the ability of the Commission to "develop an approach that bases UNE prices on a cost inquiry that is more firmly rooted in the real-world attributes of the existing network."[33] Absent current information, no one knows what the "real world" network attributes are, including the Commission and the states who would be charged with attempting to engage in such a determination. Importantly, the available data about ILEC loop plant has not been audited and cannot be verified, thus there is no way to determine whether what was being modeled would in fact be "real world" attributes and not a figment of an RBOC's imagination.

Further, a UNE costing/pricing regime incorporating "real world" attributes would, as the Commission suggested in para. 60, be anti-competitive. As discussed above in Section II. B., the RBOCs have successfully argued that they should be permitted to establish price floors based on forward-looking costs. Forward-looking costs, which reflect the on-going advances and efficiency gains in telecommunications technology, are likely to be lower than costs based in whole or in part on claimed "real world" attributes. It would be inconsistent -- and anticompetitive -- for the Commission to now reverse course and set the prices for competitive inputs based on a cost methodology that is partially reliant on embedded assumptions and data, while continuing to permit the ILECs to establish retail price floors based on forward-looking costs.[34]

The type of costing/pricing regime posited in para. 60 of the NPRM would create the worst of all possible worlds. It would result in UNE costs and prices that are based

[33] NPRM, ¶ 4; Gabel/Loube, ¶ 154-156.

[34] Gabel/Loube, ¶ 41-43.

on inefficient technology and network design, and force state commissions to set costs and prices without the ability to thoroughly analyze the data underlying assertions about the existing ILEC networks.

IV. TRANSPARENCY AND VERIFIABILITY OF COST MODELS ARE EXTREMELY IMPORTANT AND SHOULD BE CRITERIA FOR DETERMINING THE MERITS OF PROPOSED COSTS AND PRICES.

The Commission asks parties whether parties believe that there are additional goals it should consider in establishing a UNE pricing methodology, and specifically mentions two goals identified in the universal service context, transparency and verifiability:

> By transparency we mean that the logic and algorithms of a cost study or cost model should be revealed to and understandable by the parties and regulators. For example, if a cost model were presented in an electronic spreadsheet, but all the formulae were concealed so that parties could not ascertain the underlying assumptions, the model would not be transparent. By verifiability, we mean that data or inputs that are used to estimate costs should be derived from public sources, or they should be verified or audited without undue cost and delay.[35]

The Commission asks parties to comment on the importance of transparency and verifiability, whether these goals are as important as the investment and cost recovery goals discussed above, and whether there is any way for the Commission to measure whether these goals are being achieved.

Transparency is critical to the ability of regulators and interested parties to fully examine cost models and their output to determine whether they comport with TELRIC principles (or any costing principles). Rather than being an overarching goal, it should be

[35] NPRM, ¶ 41.

a fundamental criterion for determining the weight that should be accorded cost and price proposals. If cost models are not transparent, their inputs cannot be verified and their outputs cannot be audited. It is thus impossible for anyone to determine whether the resulting costs and prices comply with the Commission's rules.

In theory, verifiability is equally desirable. In practice, it is much more difficult to achieve than transparency. As discussed above in Section III, it is not possible to develop acceptable cost studies based exclusively on data that is in the public domain, because ARMIS reporting systems were not designed to track data in a manner that would permit the information to be utilized in forward looking cost models. For example, the cost of UNEs is defined to include only wholesale expenses, excluding all retail related expenses. However, in the 43-03 Joint Cost reports, Marketing (Account 6610) and Customer Services (Account 6620) are not divided between wholesale and retail activities. Therefore, it is necessary to use non-public domain information to eliminate retail expenses.[36] In another example, the 43-03 cable reports provide cable maintenance expenses by type of cable (aerial, buried or underground) but do not separate expenses by whether the cable is copper or fiber. In addition, cable investments are not divided between copper and fiber investments. This implies that expense to investment ratios derived from ARMIS must reflect the total cable investment and cannot construct a fiber- or copper-only based expense to investment ratio.[37]

Although relying on public domain data cannot create the verifiability suggested by the Commission, there is an alternative approach that can help achieve this goal. The

[36] Gabel/Loube, ¶ 152.

[37] Gabel/Loube, ¶ 153.

Commission could require that cost models and their outputs be auditable so that regulators and parties are able to replicate the cost calculations and are able to trace the outputs back through the model to the underlying inputs and assumptions. This alternative approach to verifiability would also support the goal of transparency.

The best way for the Commission to ensure transparency and verifiability is to adopt them as criteria for the existing TELRIC pricing rules so that states will apply them in the course of examining UNE costs and prices. Some states have already done this. The California Public Utilities Commission (CPUC), for example, established the following criteria for cost models in its review of Pacific Bell's UNE prices. Any cost models or cost studies filed in the proceeding must allow parties to:

1) Reasonably understand how costs are derived by:
   a. Providing access to all interested parties of the model and all underlying data, formulae, computations, software, engineering assumptions, and outputs; and
   b. Allowing interested parties to examine and modify the critical assumptions and engineering principles.
2) Generally replicate the cost model or cost study calculations; and
3) Propose changes in the inputs and assumptions in order to modify the costs produced. [38]

[38] Before the Public Utilities Commission of the State of California, Joint Application of AT&T Communications of California and WorldCom, Inc. for the Commission to Reexamine the Recurring Costs and Prices of Unbundled Switching in Its First Annual Review of Unbundled Network Element Costs Pursuant to Ordering Paragraph 11 of D.99-11-050 (A.01-02-024), etc., Scoping memo for Consolidated 2001/2002 Unbundled network Element (UNE) Reexamination for Pacific Bell Telephone Company, June 12, 2002, p. 16-17.

The Colorado Commission has adopted similar rules for transparency and verifiability.[39] The Commission can determine whether the transparency and verifiability criteria have been met by reviewing the decisions issued by the states, in conjunction with the extensive record that is developed in these proceedings.

V. THE TIME AND EFFORT THAT STATES HAVE DEVOTED TO EXAMINING TELRIC COST ANALYSES AND SETTING UNE PRICES IS APPROPRIATE AND SHOULD CONTINUE.

The Commission noted that some state UNE pricing proceedings were extremely complex and lasted for two or three years.[40] While this is true for the selected states, it does not imply that the time period was excessive, nor does it reflect that other states have completed UNE investigations in less time.

UNE pricing cases are complex, and would be regardless of what cost methodology was used to set prices. The Commission itself has understood the importance of developing a full evidentiary record in the course of deciding the Virginia arbitration proceeding, a process that took nearly three years to complete.[41]

States have decided multiple cases for more than one carrier, for good reason. Telecommunications technology evolves rapidly. It is to be expected that as the mix of technology changes, the costs change and so should the prices. State efforts to set UNE prices have saved the Commission significant amounts of time and resources. The time that the states have taken is appropriate.[42]

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[39] See 4 CCR 723-30-6; http://www.dora.state.co.us/puc/rules/723-30.pdf (accessed 12/09/03).

[40] NPRM, ¶ 6.

[41] Gabel/Loube, ¶ 85, fn. 74.

[42] Gabel/Loube, ¶ 85.

Not only do states have a legal requirement to determine UNE rates, as recognized by the Commission they also have extensive knowledge of the details of state markets, telecommunications infrastructure and the economy.[43] State regulators have extensive experience analyzing cost models for the purpose of setting prices, and are well positioned to examine the facts and make the detailed decisions that are required for determining reasonable UNEs. Such knowledge does not develop instantaneously. As states have become more familiar with TELRIC cost models, they have become more proficient at conducting UNE pricing proceedings.[44]

State commissions are the appropriate venue for determining UNE rates. In state proceedings, all parties, including consumer advocates, have an equal opportunity to present evidence and file briefs. If decisions were moved to the Commission, consumer advocates could not afford to maintain a presence in Washington, D.C. and could not effectively present a full case. The result would be that the record developed by the Commission would not be nearly as complete as it is in proceedings conducted by state regulators Unlike the FCC, state regulators hold evidentiary hearings where the assumptions and inputs that produce costs and prices are carefully tested. State regulators are in the best position to analyze the data that is specific to their states.

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[43] TRO, ¶ 425.

[44] Gabel/Loube, ¶ 86.

VI. STATE APPROVED UNE RATES ARE PREDICTABLE AND REASONABLE.

The NOPR expresses concern that "the lack of predictability in UNE rates is difficult to reconcile with our desire that UNE prices send the correct economic signals." (NPRM, ¶7) While a lack of predictability could send the wrong signals, there is strong evidence to indicate that there is not a lack of predictability in setting UNE rates. To examine the predictability of UNE rates established by the states thus far, Dr. Gabel and Dr. Loube determined several Spearman correlations for loop rates. This analysis is set forth in more detail in the affidavit supporting these comments.[45]

Spearman correlations measure the change in rank in UNE rates between one series and another. A high positive Spearman correlation would indicate that there is a consistency between the rankings of the two series. The first correlation examined was between the UNE loop rates and the average embedded loop cost as measured by the universal service high cost loop embedded cost algorithm. The correlation of embedded cost rank and forward-looking rank is indicative of the predictability of the forward-looking cost. The resulting Spearman correlation of these rankings was 0.613, indicating a statistically significant positive correlation between the two series. The second correlation was between the UNE loop rates in May, 2001 and July, 2003. The Spearman correlation was .733. This high statistically significant correlation shows that states that had relatively high UNE rates in 2001 also had relatively high UNE rates in 2003. The high positive correlation also shows that even though states have had to investigate complex TELRIC models, which "creates the potential for a TELRIC proceeding to

[45] Gabel/Loube, ¶ 88-92.

become a 'black box" from which a variety of possible rates may emerge,"[46] states have been able to see through the black box and have been able to maintain reasonable and predictable rates.[47]

Changes in the telecommunication industry have affected the pace at which state commissions address UNE pricing. In general, UNE price decreases have occurred as carriers have attempted to qualify for Section 271 approvals. For example, an NRRI study reported that for the period after July, 2002, 33 carriers received Section 271 approvals. UNE rates were decreased for 23 of the 33 carriers, approximately 70 percent. Of the remaining 16 carriers tracked UNE rates changed for only 3 carriers, approximately 19 percent.[48] This implies that most of the rate decreases were associated with carriers attempting to meet the Commission's rate benchmarks in order to obtain Section 271 approvals. In addition, it implies that the frequency of UNE rate cases will decrease now that carriers have succeeded in obtaining Section 271 authorization. The corresponding reduction in caseload will reduce the regulatory burden on both state commissions and the carriers.

Therefore, there is no need for the Commission to take extraordinary steps to reduce the regulatory burden. Instead, the Commission should allow the states to continue to address required changes in UNE rates whenever the state commission determines on its own discretion that there is a need to review the rates, or whenever parties petition the state commission to review the rates.

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[46] NPRM, ¶ 7.

[47] Gabel/Loube, ¶ 90-92.

[48] Gabel/Loube, ¶ 93-94; National Regulatory Research Institute, A Survey of Unbundled Network Element Prices in the United States, www.nrri.ohio-state.edu/documents/uneprices, and www.cad.state.wv.us

VII. IT IS EXTREMELY UNLIKELY, IF NOT IMPOSSIBLE, THAT THE COMMISSION COULD SUCCESSFULLY SET UNE RATES TO PROMOTE FACILITIES BASED ENTRY.

One primary goal of the Commission's UNE pricing rules is to "set UNE prices in a manner that sends efficient entry and investment signals to all competitors."[49] In paragraphs 2-3, the Commission appears to be suggesting that it take this goal one step further by modifying its pricing rules to promote facilities-based entry. This is a much different, and much more granular objective than the goal of sending appropriate price signals to potential entrants. It would be extremely unlikely, if not impossible, for the Commission to develop rules that result in prices that strike the proper balance between encouraging facilities-based entry and price competition.

Developing a pricing regime that is specifically targeted toward promoting facilities-based entry would greatly exacerbate the complexity of setting UNE prices, and increase the resources required for the effort. It would require the building of business case models for both entrants and incumbents in order to determine what price levels make an economically significant difference in a firm's investment decisions. Construction of business models is extremely problematic. Demand forecasting and cost estimation is at the heart of building a business model. The Commission cannot effectively determine the entrants' cost structures if it cannot effectively forecast either the incumbents' or the entrants' revenues that would be generated from new facilities.[50]

[49] NPRM, ¶ 38.

[50] Gabel/Loube, ¶ 70.

The state TELRIC proceedings have illuminated the fact that understanding the cost structure of ILECs is extremely difficult. Cost modeling, no matter what methodology and models are used, cannot provide the precision necessary for it to be used for the purpose of developing prices to promote entry.[51]

The Commission has no means of obtaining verifiable information on the profitability of entry. It is nearly impossible for the Commission to obtain credible long-run forecasts of demand for services. If such information were somehow to be obtained, the Commission would still need to be able to model how an entrant anticipates an incumbent will react to its entry, since a potential entrant's decision is influenced by its belief about what will happen to prices and service offerings after it enters the market.[52]

If the Commission attempts to set UNE prices in order to provide incentives for facilities-based competition, it will be necessary to accurately forecast the entrants' costs, forecasted demand, and beliefs about the evolution of the industry. The "telecommunications meltdown" of 2000 came about when too much was invested in the industry on the basis of inaccurate forecasts and misguided "market exuberance."[53] Whether the Commission can do a better job than Wall Street of predicting the future market for facility-based entry is an open question.

In light of these concerns, the Commission should not try to target the UNE pricing mechanism to encourage investment. Instead, the Commission should let the market do its job. The Commission and state regulators should focus on the task that

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[51] Gabel/Loube, ¶ 71.

[52] Gabel/Loube, ¶ 72.

[53] Larry F. Darby, Jeffrey A. Eisenbach, and Joseph S. Kraemer, The CLEC Experiment: Anatomy of a Meltdown, Release 9.23, Periodic Commentaries on Policy Debate, The Progress and Freedom Foundation (September 2002), p. 19; Gabel/Loube, ¶ 73, 76.

they can do well – obtain a good estimate of the cost of UNEs pursuant to their statutory requirement, and then leave it to private firms to decide when it makes good economic sense to enter the telecommunications market.[54]

VIII. CONCLUSION

NASUCA urges the Commission to retain the current TELRIC rules. In this NPRM, the Commission reaffirmed its commitment to forward-looking costing principles. In doing so, the Commission concluded that the decision remains sound to base UNE prices on forward-looking costs, and noted the supreme court's endorsement of the Commission's forward-looking costing methodology and its concerns regarding alternative pricing methodologies that rely in whole or in part on embedded costs. (NPRM, ¶ 37)

For the reasons set forth in these comments, it would be extremely unwise to modify the UNE pricing rules to incorporate the methodology, assumptions or data utilized in embedded cost studies, i.e., the "existing networks" of the ILECs. UNE pricing cases would be complex, regardless of what costing methodology was used to set prices. Modifying TELRIC to introduce an embedded cost component would not suddenly alter this fundamental fact. The assumptions and inputs associated with embedded costs are not supported by public data, and cannot be verified, and it is extremely unlikely that the purported "actual costs" are accurate. The use of embedded costs would not reduce the speculation about UNE costs and prices about which

[54] Gabel/Loube, ¶ 80.

Commission has expressed concern, nor would it reduce the complexity of state UNE proceedings – to the contrary, the complexity would increase.

The Act charges states with the legal requirement to determine UNE rates. State regulators now have extensive experience analyzing TELRIC costs and they have a great deal of knowledge of the details of the state-specific conditions, including markets, telecommunications infrastructure, and the economy. States are well-positioned to examine the facts and make the detailed decisions that are required for determining reasonable UNE prices.

For these reasons, and those set forth in these comments and in the attached affidavit, the Commission's primary UNE pricing goals are best achieved be retaining the existing TELRIC pricing regime, including the key role accorded by the Act to states.

Respectfully submitted,

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